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BEFORE THE

Supreme Court of the United States

OCTOBER TERM, 1943.

No. 937

ESTATE OF JOHN W. HERBERT, Deceased, CENTRAL HANOVER BANK AND TRUST COMPANY, ET AL., Executors, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT, BRIEF IN SUPPORT THEREOF, AND MOTION AS TO RECORD.

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v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable, the Chief Justice and the Associate Justices:

The petition of the Estate of John W. Herbert, Deceased, Central Hanover Bank and Trust Company, et al., Executors, respectfully shows to this Honorable Court:

A.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

1. Statement of the Case.

John W. Herbert died on August 26, 1934. His executors are the petitioners in this litigation which involves the liability of the estate for income taxes on payments

received by the estate in 1938 and 1939 on account of notes and open book accounts held by the decedent. When Herbert died he had a claim of $531,817.75 (R. 19a) against the People's Realty Company of which he was the sole stockholder. The entire claim originated in cash loans and advances made by the decedent to said company. The parties stipulated that the fair market value of this claim at the date of death was $200,191.90. (R. 19a) The executors to whom the claim passed as an asset of the estate, collected on the claim, by the end of 1937, $155,000.00; in 1938, $127,000.00; in 1939, $500.00 (R. 19a), and interests in two mortgages, having an aggregate fair market value of $13,303.61 (R. 20a). The aggregate of the payments received from the debtor company on account of its total indebtedness to the decedent, or his estate, respectively, therefore amounted to $295,803.61, leaving an unpaid indebtedness of $236,014.14. The executors did not include in the gross income of the estate for 1938 and 1939 any part of the amounts collected over and above the stated fair market value of the claim at the date of death. The Commissioner of Internal Revenue added $81,808.10 (R. 14a), the amount by which collections in 1938 had exceeded the fair market value of the claim, to the ordinary income of the 1938 return, and $13,803.61 (R. 19a), the amount collected in 1939, to the ordinary income on the return of that year. The tax Court, by its Memorandum Opinion of March 4, 1943 (R. 20a-21a), and its decision of May 20, 1943 (R. 21a), sustained the Commissioner and the case was taken for review to the United States Circuit Court of Appeals for the Third Circuit. By its decision of December 30, 1943, to wit, Herbert's Estate et al. v. Commissioner of Internal Revenue, 139 Fed. (2d), Advance Opinions 756, the decision of the Tax Court was affirmed (R. 22-27).

The Commissioner relied on Sections 111, 22(a) and 161(a) (3) of the Revenue Act of 1938, corresponding sections of the Internal Revenue Code and, for judicial precedent, on *Helvering* v. *Roth* (2 Circ. 1940), 115 Fed. (2d) 239.

2. Questions Submitted to the United States Circuit Court of Appeals for the Third Circuit and the Answers Given Thereto in the Decision of that Court.

The petitioners submitted, on appeal, the following questions:

> Is the partial repayment of loans, made by the decedent prior to his death, as far as such repayments exceed the assumed fair market value of the total indebtedness as of the date of death of the decedent, taxable income of the estate?

In particular:

> (a) Does such partial repayment of a loan constitute a "sale or other disposition" of property on the part of the executors as required for the determination of taxable gain under section 111(a) and (b) of the Internal Revenue Code?
>
> (b) Can the doctrine of separate taxable entity of an estate be used to make income out of what is not in truth and substance income?
>
> (c) Is the hypothesis of the "fair market value", in view of the contingencies under which it had to be assumed by the executors in the case at bar, subject to the corrective of subsequent events?
>
> (d) May the mandatory application of a basis under Section 113(a) (5) of the Internal Revenue Code be interpreted as amounting in effect to a statutory write-off of a bad debt to the extent to which the assumed fair market value is below the full amount of the debt?

The United States Circuit Court of Appeals for the Third Circuit Court gave the following answers to the foregoing questions:

It held the partial repayment of loans made by the decedent prior to his death, as far as such payments exceeded the fair market value of the total indebtedness as of the date of the death of the decedent, to be ordinary

taxable income of the estate. In particular, the court held that the payment of the claim held by the estate was a "disposition" of the claim within the meaning of Section 111 of the Revenue Act of 1938 and of the Internal Revenue Code, and, further, that, whatever status a personal representative may have for other purposes, he is treated by the Revenue Acts as a new owner of the decedent's property for income tax purposes and that the claim held by the estate cannot be considered as the expression of a creditor-debtor relationship continued from the decedent unto his executors.

The court also held that Section 22(a) of the Revenue Act of 1938 (corresponding section of the Internal Revenue Code), is broad enough to include the difference between the value of the claim on the date of death and the amount ultimately collected on the claim, in the categories of gross income enumerated in this section. In other words, the court held that the excess collected over the assumed fair market value at the date of death is returnable as ordinary income under section 22(a) of the 1938 Act, or the corresponding section of the Internal Revenue Code, notwithstanding the fact that Congress has prescribed a definite and exclusive method for the determination of gain or loss in the case of a "sale or other disposition" of property in sections 22(f) and 111(a) and (b), respectively; that is to say, the application of Section 111(a) and (b) is mandatory in cases where gain or loss is to be determined as the difference from a given basis, as for example, in the case at bar, from the date of death value basis under Section 113(a) (5) of the Revenue Act of 1938 (corresponding section of the Internal Revenue Code). (R. 3a)

B.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

A writ of certiorari should be granted under subdivision 5(b) of Rule 38 of this Honorable Court for the following reasons:

1. A substantial federal question is presented.

In *Helvering* v. *Griffith*, 318 U. S. 371, 87 L. Ed. 843, this Honorable Court expressly refused to overrule its decision in *Eisner* v. *Macomber*, 252 U. S. 189, 64 L. Ed. 521. *Inter alia*, this Honorable Court stated as follows:

> "Like earlier Acts, the Revenue Act of (May 28) 1938, as proposed and enacted, contained provisions intended to conform with the authority of Eisner v. Macomber."

Preceding the narrower issue, to wit, whether stock dividends should be taxed as income of the recipient, this Honorable Court discussed in *Eisner* v. *Macomber* the more basic question of what the framers of the 16th Amendment meant generally by the term "income", "as used in common speech, to determine its meaning in the Amendment". It was found that the general definition of income, namely: "* * * The gain derived from capital, from labor, or from both combined, provided it be understood to include profits gained through a sale or conversion of capital assets", contained the same fundamental conception as "clearly set forth in the 16th Amendment." The decision of the appellate court in the case at bar is in conflict with this "fundamental conception" of income in the 16th Amendment, that is, as this term is understood in common speech. In holding the partial repayment of a debt, of which a large part remains unpaid, although the total payments collected exceeded the fair market value at the date of death of the decedent, to be ordinary income, the appellate court in the case at bar disregarded the fact that the power of Congress to tax income is *limited* by the 16th Amendment and that such limitation prevents the taxation of collections on a debt as income because they are not in fact income, that is, as the term "income" is understood and used in common speech and in the 16th Amendment. This constitutional limitation is not to be over-ridden by Congress or disregarded by the courts.

2. The decision of the United States Circuit Court of Appeals for the Third Circuit is in conflict with decisions of this Honorable Court on similar matter.

(a) The decision of the appellate court in the case at bar is in conflict with decisions of this Honorable Court in *Goodrich* v. *Edwards,* 255 U. S. 557, 65 L. Ed. 758, *Walsh* v. *Brewster,* 255 U. S. 536, 65 L. Ed. 762 and *United States* v. *Flannery,* 268 U. S. 98, 69 L. Ed. 865, in that said decision of the court below disregarded the interpretation of this Honorable Court to the effect that the introduction of a basis (March 1, 1913) for the purpose of gain or loss determination constitutes a *limitation* upon "actual" gain, as far as such gain represents "income" as contemplated by the 16th Amendment and defined in *Eisner* v. *Macomber, supra.*

(b) The decision of the appellate court in the case at bar is in conflict with the decision of this Honorable Court in *Dobson* v. *Commissioner of Internal Revenue,* Nos. 44, 45, 46, 47, October Term 1943, Adv. Op. 88 L. Ed. 179, in that by that decision this Honorable Court confirmed the procedure of the Tax Court to look to prior years "to determine the *nature of the recovery, whether return of capital or income,*" and stated:

> "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. . . . The Tax Court analyzed the basis of the litigation which produced the recovery in this case and the obvious fact that regarding the series of transactions as a whole it is apparent that no gain was *actually* realized'." (Italics supplied.)

The above decision of this Honorable Court assumes particular significance if applied to the holding of the Tax Court in *Estate of Harris Fahnestock, et al.* v. *Commis-*

sioner of Internal Revenue, 2 T. C. No. 96, in that the court there allowed a partial deduction of a bad debt owed the decedent, the date of death value serving as a basis for the determination of such deduction, and in that in the case at bar neither the decedent, nor his estate, have claimed or received any income tax benefit represented by the difference between the amount advanced by the decedent and the fair market value at the date of his death.

3. The decision of the United States Circuit Court of Appeals for the Third Circuit is in conflict with an interpretation of the United States Court of Claims on the same matter.

The decision of the appellate court in the case at bar is in conflict with an interpretation of the United States Court of Claims in *Elmhirst* v. *United States*, 38 Fed. (2d) 915, in which decision that court stated as follows:

> "It thus seems that had Congress inserted a further provision that when the sale was made by an executor the basis for estimating the gain would be the gain as between the value at the time of the testator's death and the sales price, the *Supreme Court would have held that this was merely a 'limitation' which would not control against the 'actual gain' as shown between the purchase price and the sales price.*" (Italics supplied.)

4. The decision of the United States Circuit Court of Appeals for the Third Circuit is in conflict with other circuit courts of appeal on the same matter.

(a) The decision of the appellate court in the case at bar is in conflict with the decision of *First Savings Bank of Ogden* v. *Burnet*, 53 Fed. (2d) 919, decided by the United States Court of Appeals for the District of Columbia, holding that, in construing the term "*sale or other disposition*", the rule of *ejusdem generis* is applicable.

(b) The decision of the appellate court in the case at bar is in conflict with the decision of the United States

Circuit Court of Appeals for the Fifth Circuit in *United States* v. *Carter,* 19 Fed. (2d) 121, holding that a claim of a decedent, although more was collected thereon than was assumed to be the fair market value at the date of death of the decedent, was "part of the corpus of the estate of the decedent", an "integral part of the corpus of the estate", stating as follows:

> "What the appellees (to wit, the executors of the estate) have received from that source came to them as part of the corpus of the estate of the deceased. *They have not sold, converted, or otherwise disposed of that asset, or any part of it.* No income accrued to the estate of the deceased, or to the executors of his will, from the fact that the executors, in making the return for estate tax purposes, estimated the value of deceased's interest in his firm at less than it actually was worth. *All along the appellees were entitled to what the deceased's interest in the firm actually was worth.*" (Italics supplied.)

5. The decision of the United States Court of Appeals for the Third Circuit is in conflict with the position taken by the Commissioner of Internal Revenue in a factual situation analogous in principle and a decision of the Board of Tax Appeals, now the Tax Court.

The decision of the appellate court in the case at bar is in conflict with the decision of the Board of Tax Appeals, now the Tax Court, in *Estate of Edith Findlay,* 46 B. T. A. 1214, in which case the Commissioner of Internal Revenue took the position that the receipt of property, consisting of stocks, bonds and cash from the testatrix by the estate of a devisee is not a disposition within the meaning of the statute, and, therefore, the petitioner is not entitled to deduct any loss represented by the difference in value between the assets received by the estate of the devisee and their fair market value at the date of death of the devisee, the court, in upholding the Commissioner, stating as follows:

"However, assuming for the purpose of discussion that the basis is about $124,000, and even though the fair market value at the date of distribution by the estate of the testatrix was about $98,000, *we can see no disposition within the meaning of Section 111(a), Revenue Act of 1936.* . . . Since the property received was not disposed of in the taxable yar, we fail to perceive anything other than *a mere fluctuation in value which does not give rise to a deductible loss.*" (Italics supplied.)

Wherefore your petitioners respectfully pray that the writ of certiorari be issued out of, and under the seal of, this Honorable Court, directed to the United States Circuit Court of Appeals for the Third Circuit, to the end that the decision of the United States Circuit Court of Appeals for the Third Circuit, rendered in the case numbered and entitled on its Docket No. 8500, Estate of John W. Herbert, Deceased, Central Hanover Bank and Trust Company et al., *Petitioners,* v. Commissioner of Internal Revenue, *Respondent,* be reviewed and determined by this Honorable Court and your petitioners may have such other and further relief in the premises as to this Honorable Court may seem meet and just.

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